

Chapter III

Regulatory Compliance

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Introduction

In this audit area, we focus on the Company's compliance with the conditions pertaining to merger costs and savings, cost allocation and internal compliance programs outlined in the Illinois Commerce Commission (ICC or Commission) and Federal Communications Commission (FCC) merger orders as these orders relate to matters within the scope of this investigation.

Illinois Commerce Commission Order

The merger of SBC and Ameritech constituted a reorganization of Ameritech Illinois under Section 7-204 of the Illinois Public Utilities Act (PUA) and required approval by the Illinois Commerce Commission. SBC, Ameritech Illinois, and Ameritech Illinois Metro (collectively "Joint Applicants") first filed an application seeking Commission approval of the merger in July 1998. On September 23, 1999, the Commission entered its Order approving the merger, subject to certain conditions that are described below.

The ICC Order addresses several issues, ranging from the impact of the proposed reorganization on Ameritech Illinois' ability to provide adequate, reliable, and least-cost service, to whether the merger would have a significant adverse effect on competition and whether it would result in adverse rate impacts.

Two issues addressed in the ICC Order pertain specifically to this audit and are summarized below:

Exhibit RC-1 ICC Order Issues Pertaining to SBC/Ameritech Cost Savings and Allocations

ICC Order Issue	Description
C	Whether the proposed reorganization will result in the unjustified subsidization of non-utility activities by the utility or its customers. (Section 7-204(b)(2)) Whether costs and facilities are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes. (Section 7-204(b)(3))
H	Rulings pursuant to Section 7-204(c) – Allocation of Savings

Source: Illinois Commerce Commission Order, Docket 98-0555, September 23, 1999. pp. 32 and 36.

Issue C – Unjustified Subsidization

PUA Section 7-204(b)(2) requires the Commission to determine that the proposed reorganization will not "result in the unjustified subsidization of non-utility activities by [Ameritech Illinois] or its customers" in Illinois. The Commission's duty under this section of the PUA is to ensure that the proposed reorganization will not lead Ameritech Illinois to

assign costs from its competitive, non-utility functions to its non-competitive, utility activities in a manner not currently allowed by Illinois law and Commission rules.

Significant Commission findings regarding unjustified subsidization are listed below:

- The Commission found that the reorganization would not result in the unjustified subsidization of non-utility activities by the utility or its customers. (Order at 36)
- The Commission concluded that Ameritech Illinois is currently in compliance with the cost allocation and affiliate transaction rules promulgated by the Commission. (Order at 36)
- The Commission found that the Joint Applicants' voluntary acceptance of certain conditions, including the updated CAM procedures further ensures the continuing compliance by Ameritech Illinois with the Commission's cost allocation rules. (Order at 37)
- The Commission ordered the Joint Applicants to update the CAM in the manner proposed by Staff:

Updates of the relevant CAM item must occur whenever either the cost allocation methodology or the identification of affiliates or services provided or received by Ameritech Illinois changes.

- Ameritech Illinois must include in its CAM a brief description of each of Ameritech's affiliates as well as detailed information regarding the transactions which occur with those affiliates.
 - ⇒ These updates must be completed within sixty days of final state and federal regulatory approval of the reorganization.
 - ⇒ Conditions concerning updated CAMs are to be complied with by the Joint Applicants and reviewed and audited by the Commission with the assistance of an independent third party selected by the Commission and paid for by the Joint Applicants. (Order at 37 and 38)
- The Commission found that transferring employees from one job to another within the merged company is not cross-subsidization so long as Ameritech Illinois properly accounts for the transfer in accordance with current and future practices outlined by the Commission. (Order at 38)

PUA Section 7-204(b)(3) requires the Commission to determine that the "costs and facilities [of Ameritech Illinois] are fairly and reasonably allocated between utility and non-utility activities in such a manner that the Commission may identify those costs and facilities which are properly included by the utility for ratemaking purposes." (Order at 41)

Significant Commission findings regarding allocations for ratemaking purposes are listed below:

- The Commission found no reason why Ameritech Illinois could not comply with 83 Illinois Administrative Code Part 285, which requires a summary of affiliated interest transactions. The Commission put the Joint Applicants on notice that illegal cost allocation among affiliates will be penalized to the fullest extent of Illinois law. (Order at 42)
- The Commission incorporated Staff's proposed conditions granting Staff access to all books, accounts, records, independent audit work papers, personnel, etc. of the regulated and non-regulated utility affiliates of the Joint Applicants which the Commission and Staff deem necessary. In addition, the Commission required the Joint Applicants to reimburse the Commission Staff for all reasonably incurred travel expenses if Staff must travel out of Illinois in order to review the Joint Applicants' books and records. (Order at 42)

Issue H - Allocation of Savings

PUA Section 7-204(c) requires the Commission to rule on (i) the allocation of any savings resulting from the proposed reorganization; and (ii) whether the companies should be allowed to recover any costs incurred in accomplishing the proposed reorganization and, if so, the amount of cost eligible for recovery and how the costs will be allocated. (Order at 125)

Significant Commission findings regarding the allocation of cost savings are listed below:

- The Commission agreed with the Joint Applicants that the term "savings" in Section 7-204(c)(i) refers to an actual reduction in costs or expenses. Savings does not mean generating more revenue or "revenue enhancements". As for the meaning of "costs", the Commission agreed with the Staff that none of the merger "transactional costs" should constitute legitimate costs for present purposes. (Order at 147 and 148)
- The Commission believes that both the savings and the costs of the merger transaction as well as their reasonableness must be determined when actual data, as opposed to estimates, are available. (Order at 148)
- The Commission concluded that 50 percent of the net merger savings allocable to AI should be allocated to consumers using Staff's distribution methodology. (Order at 148)
- The Commission directed the Joint Applicants to follow Staff's Interim Method until the appropriate mechanisms are made in the five-year review of the alternative regulatory plan. Specifically:
 - ⇒ Ameritech Illinois was required to track its share of all actual merger-related savings and all merger-related costs separately for the period beginning on the date that the merger is consummated and ending on December 31, 1999.¹
 - ⇒ AI was required to submit that information as part of its annual Alternative Regulation filing on April 1, 2000.¹

¹ March 15, 2000 original date modified to December 31, 1999 in the November 15, 1999 Amendatory Order.

- ⇒ This information will continue to be provided in Ameritech's annual price cap filings until such time as an updated price cap formula has been developed in Docket 98-0252. In the annual price cap filings, AI is required to flow-through merger savings net of reasonable costs in the manner described in the order until such time as an updated price cap formula has been developed. (Order at 150)
- The Commission decided to retain, at the Joint Applicants expense, a third party auditor to develop and establish accounting standards to assist the Commission in identifying such costs and savings and to assist the Commission in tracking and determining the amount of such costs and savings. The auditor reports to and is governed by the directives of the Commission. The Commission noted the difficulty of identifying and determining such costs and savings and required the Joint Applicants to retain and to continue to provide to the Commission information using the Uniform System of Accounts for Ameritech Illinois until at least such time as an updated price cap formula has been developed in Docket 98-0252 (Docket relating to the Commission-ordered five year review of Ameritech's alternative regulation plan). (Order at 150)
 - The Commission ruled that the net merger-related savings should be allocated to Ameritech Illinois' customers as follows:
 - ⇒ Carriers purchasing AI's unbundled network elements (UNEs), interconnection, and transport and termination services will benefit from merger-related savings through updated rates resulting from modification of its TELRIC, shared and common costs.
 - ⇒ Once the share of the merger-related savings allocable to UNEs, interconnection, transport and termination purchasers have been identified, the remaining balance of savings will be allocated to interexchange, wholesale and retail customers. This will be done by dividing the remaining merger-related savings between IXC's on the one hand and end users (whether served via retail or wholesale) on the other, based on the relative gross revenues of each of these two groups. (Order at 150)
 - IXC's' share of the merger-related savings should be allocated to those customers through reductions in access charges, including the intrastate PICC. End users' share of the merger-related savings should be allocated as a credit on a per network access line basis to ensure that business customers do not receive a larger portion of the merger-related savings than residential customers. (Order at 151)

Conditions Pertaining to Cost Savings and Allocations

The ICC Order lists 32 conditions related to the approval of the SBC/Ameritech merger. Conditions 16, 25 and 26, directly pertain to the audit of merger-related savings and SBC/Ameritech compliance reporting and are listed in Exhibit RC-2 (page following).

ⁱ Ameritech Illinois' rates are determined in accordance with an alternative regulation plan. (Docket 92-0448) The Company may adjust its rates within the constraints of a price cap index that reflects the impact of inflation and productivity, as well as exogenous events and changes in service quality. There is no direct regulatory oversight of Ameritech Illinois' earnings or its depreciation rates, except that the depreciation rates used to calculate the revenue requirements implementing the alternative regulation plan shall also be used to calculate long run service incremental costs over the course of the plan.

Exhibit RC-2
ICC Order Merger Conditions Pertaining to Cost Savings and Allocations

Merger Condition 16: CAM

- Revisions - The Joint Applicants agree that Ameritech Illinois will file revisions to Cost Allocation Manuals ("CAM") within sixty (60) days of the date of receipt of the last regulatory approval required for the proposed merger;
- AIA - The Joint Applicants will provide Staff with a copy of each affiliate service agreement and the relevant updated CAM pages to resolve any cost allocation issues in a complete and timely manner;
- Updates - The Joint Applicants will continue to provide Staff with any and all relevant updates to the CAM before providing service under any new or revised affiliate agreements;
- Personnel Training - Applicants agree to inform all relevant company personnel that the CAM has been revised, provide easy access to the revised manual and train personnel as to its proper application;
- Third-party Audit - Conditions concerning updated CAMs are to be complied with by the Joint Applicants and reviewed and audited by the Commission, with the assistance of an independent third party selected by the Commission and paid for by the Joint Applicants.

Merger Condition 25: Enforcement and Compliance Monitoring

- Joint Applicants shall appoint and identify to the Commission a corporate officer to oversee implementation of, and compliance with these commitments; to monitor Joint Applicants' progress toward meeting the deadlines specified in the order; to provide periodic reports regarding Joint Applicants' compliance as required; and to ensure that any payments due under these commitments are timely made.
- The compliance officer will report directly to the audit committee of SBC/Ameritech's Board of Directors, who will oversee the corporate compliance officer's fulfillment of these responsibilities.
- No later than 6 months after the merger closing, and annually thereafter until the expiration of each of these commitments, Joint Applicants will file with the Commission, a report detailing its compliance with these commitments and make a copy of its most current compliance report publicly available on their Internet site.
- Joint Applicants will, at their own expense, annually engage independent auditors to verify SBC/Ameritech's compliance with these commitments. The first compliance review will be due one year after the merger closing and compliance reviews covering a period of three years after the merger closing will be submitted.
- If the Commission makes a determination, after due process, that Joint Applicants have during the effective period of a condition materially failed to comply with that condition, the Commission may, at its discretion, extend the effective period of that condition for a period that does not exceed the period during which Joint Applicants materially failed to comply with the condition.
- Joint Applicants will make payments due under these commitments within 10 business days of a determination by Joint Applicants' compliance officer, the Commission, or an arbitrator, that payment is due.

Merger Condition 26: Recordation of All Savings and Costs

- The Joint Applicants will be held responsible for recording all savings and all costs relating to the merger in the manner described in the order with the ultimate result that 50% of the net merger savings be allocated to customers. This measure puts the burden on the Joint Applicants to affirmatively evidence compliance in all particulars thus conserving Staff's time and resources.
- The Commission shall hire, at the Joint Applicant's expense, a third-party auditor to develop accounting standards and assist the Commission in tracking merger related savings. The third-party auditor shall report to, and be governed by the directives of the Commission.

Source: Order, pp. 247 – 250.

Federal Communications Commission Order

On October 8, 1999, the FCC issued an order granting the SBC/Ameritech merger subject to 30 conditions designed to further open these companies' local markets to competition, stimulate the deployment of advanced broadband services, and to strengthen the merged firm's incentives to expand competition outside its 13 state service area. The FCC found that with these conditions the merger was in the public interest. Upon consummation of the merger, SBC controlled three of the original seven Regional Bell Operating Companies (RBOCs), namely SBC's Southwestern Bell Telephone, Pacific Telesis and Ameritech.

The 30 conditions adopted by the Commission were designed to accomplish five central public interest goals:

1. Promote equitable and efficient advanced services deployment;
2. Ensure open local markets;
3. Foster significant out-of-region competition for the first time by a Bell Operating Company;
4. Improve residential phone service; and,
5. Ensure compliance with and enforcement of the conditions.

These goals flow from the FCC's statutory objectives to open all telecommunications markets to competition, to promote rapid deployment of advanced services, and to ensure that the public has access to efficient, high-quality telecommunications services.

The FCC Order found that, absent these conditions, the proposed merger would harm consumers of telecommunications services by:

- Denying them the benefits of future probable competition between the merging firms;
- Undermining the ability of regulators and competitors to implement the pro-competitive, deregulatory framework for local telecommunications that was adopted by Congress in the Telecommunications Act of 1996; and,
- Increasing the merged entity's incentives and ability to raise entry barriers to, and otherwise discriminate against, entrants into the local markets in its region.

Three of the conditions in the FCC Order are of particular relevance to the Commission's SBC/Ameritech Merger Investigation and are listed in Exhibit RC-3 below.

Exhibit RC-3
FCC Order Merger Conditions Pertaining to Cost Savings and Allocations

Merger Condition 24: Additional Service Quality Reporting

- On a quarterly basis, SBC/Ameritech will report the quality of service that it provides its customers in accordance with the NARUC Technology Policy Subgroup's November 1998 "Service Quality White Paper."
- SBC will develop and file reports showing the service quality provided to interexchange carriers.
- SBC/Ameritech will continue reporting ARMIS data on an operating-company basis.
- This condition will safeguard against potential deterioration in SBC's or Ameritech's quality of service as a result of the merger and promote affirmative service quality improvements.

Merger Condition 26: Internal Compliance Program

- Prior to the close of the merger, SBC/Ameritech will appoint an internal corporate Compliance Officer who will prepare and publicly file with the Commission an annual report addressing the company's compliance with the merger conditions.
- This condition will ensure that SBC/Ameritech has internal controls in place to maintain full and timely compliance with the conditions.

Merger Condition 27: Independent Auditor

- SBC/Ameritech will retain an independent auditor, approved by the Commission, to provide a thorough and systematic evaluation of its compliance with the conditions and determine the sufficiency of its internal controls. The auditor will issue reports that will be publicly available.
- This condition establishes an efficient and cost-effective mechanism for detecting potential noncompliance with the conditions.

Source: FCC Docket No. 98-141, FCC Memorandum Opinion and Order, adopted October 6, 1999.

Audit Objectives

- Determine whether AI has filed revisions to its CAM within 60 days of the date of the last regulatory approval (October 8, 1999) required for the merger.
- Determine whether AI has provided the Commission Staff with a copy of each affiliate company service agreement and the relevant updated CAM pages.
- Determine whether AI has provided the Commission Staff with all relevant updates to the CAM before providing service under any new or revised affiliate agreements.
- Determine whether SBC has complied with those portions of Conditions 24, 26 and 27 of the FCC Merger Order relating to Service Quality Reporting, implementation of an Internal Compliance Program and Independent Auditor evaluation that have implications within the scope of this investigation.
- Determine whether there are other merger related regulatory compliance issues contained in the FCC and Commission record of proceedings with possible relevance to matters within the scope of this investigation.

Evaluative Criteria

- Is AI in compliance with the Commission's merger related filing requirements with respect to its CAM?
- Are current cost allocation practices and procedures in compliance with Commission and FCC guidelines?
- Has AI clearly established organizational responsibilities and effective procedures to address merger related regulatory compliance on an on going basis?
- Has SBC complied with FCC Merger Order conditions that have implications that are within the scope of this investigation?

Summary of Audit Procedures

- Reviewed relevant SBC and Ameritech documents including
 - ⇒ Commission and FCC merger orders
 - ⇒ Log of Intervenor Data Requests in merger Docket 98-0555 and selected responses
 - ⇒ Post-merger ICAM and Affiliate Service Agreements
 - ⇒ SBC, Ameritech and AI regulatory policy and accounting manuals
 - ⇒ AI ARMIS Joint Cost Reports 43-03 and related reports of independent auditors for the years ended December 31, 1998 and 1999
- Reviewed SBC billings to Ameritech for services provided subsequent to the merger.
- Tested the Company's compliance with selected FCC merger reporting and compliance requirements.

Findings and Conclusions

1. AI has complied with the Commission's requirements relating to the filing of updated Cost Allocation Manuals, Affiliate Service Agreements and Compliance Reporting set forth in the Merger Order in Docket 98-0555.
 - The Company filed an updated Illinois Cost Allocation Manual (ICAM) on December 6, 1999, within 60 days of the date of the last regulatory approval (October 8, 1999).
 - The updated ICAM identifies new affiliates and defines the scope of transactions with AI as shown in Exhibit RC-4 on the page that follows.

Exhibit RC-4
Transactions with Post-Merger Affiliates

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New AI Affiliate	Scope of Services	Transaction Volume
SBC Management Services	Administrative and Support Services	(redacted)
SBC Operations, Inc.	Planning, development, sale and merchandising of telecommunications services and products	(redacted)
SBC Services, Inc.	Transaction processing including billing, payroll, accounts payable, customer remittance, fixed asset record-keeping and general ledger processing.	(redacted)
Southwestern Bell Mobile Systems, Inc.	Wireless services to AI at prevailing price.	(redacted)

Source: Illinois Cost Allocation Manual (Document Request IDR 1.8).

- Under PUA 13-601, the Company is required to file affiliate service agreements when transactions under the agreements exceed \$5 million. AI has interpreted this dollar threshold as an annual amount.
 - The Company filed Service Agreements for SBC Management Services and SBC Operations, Inc. on December 6, 1999, prior to any transactions with these affiliates.
 - The Company filed a Merger Compliance Report dated April 10, 2000 with the verification letter required by Condition 31 of the merger order.
2. Neither the Company nor the ICC Chief Clerk can confirm that all affiliate service agreements required to be filed in fact have been filed.
- The Company advised us that nine Ameritech affiliate service agreements were filed prior to the closing of the SBC/Ameritech merger. The ICC Chief Clerk advised us that the filing of these agreements could not be confirmed without specific information regarding docket numbers or the approximate filing dates.
 - The Company does not retain date stamped copies of transmittal letters relating to the filing of affiliate service agreements with the Commission.
3. Although the ICAM and Ameritech Cost Allocation Manual (ACAM) should be essentially the same, there are several general ledger accounts referenced in the ACAM that are not included in the ICAM.
- These two documents are intended to be identical, other than minor terminology differences.

- The ACAM and ICAM were most recently updated on December 6, 1999. Significant changes were made to both the ACAM and the ICAM, including changes required because of the merger. The Part 32 account structure was not significantly changed.
 - Approximately 30 expense accounts that are included in the ACAM are not shown in the ICAM. According to AI, there are differences between the accounts listed in the ACAM and ICAM because the Cost Apportionment Methodology section of ICAM is for illustrative purposes. The ACAM is used in the Part 64 Cost Allocation System (PCAS) for AI.
 - According to the Company, although the ACAM was updated through annual filings, the Cost Apportionment Methodology section of the ICAM was not routinely updated because it was not used in the PCAS.
4. There are a number of differences between AI's ICAM and 83 Illinois Administrative Code Part 711.
- Part 711 is the Commission's Telecommunications Cost Allocation Manual for large local exchange carriers, which provides the allowable bases for allocation of costs and requires the filing of an Illinois CAM.
 - As shown in Exhibit RC-5 below, there are differences between the ICAM and Part 711 for each of the ten Part 32 accounts selected by BWG for detailed testing of the Company's cost allocation procedures. (See Chapter VI) In general, the ICAM contains a more detailed listing of cost pools for each account than is shown in Part 711.

Exhibit RC-5
Comparison of ICAM and Part 711 Descriptions of Selected Part 32 Accounts

Expense Account		Differences Between ACAM and ICAM	Differences Between ICAM and Part 711
6121	Land & Building	None	Use different cost pools
6124	General Purpose Computers	Account not in ICAM	Account not in ICAM
6212	Digital Electronic	None	Use different cost pools
6423	Buried Cable	Account not in ICAM	Account not in ICAM
6533	Testing	None	Use different cost pools
6534	Plant Ops. & Admin.	None	Use different cost pools
6561	Depreciation	None	Use different cost pools
6612	Sales	Account not in ICAM	Account not in ICAM
6623	Customer Service	None	Use different cost pools
6728	Other General & Admin.	None	Compensated Absence not in Part 711

Source: Illinois Cost Allocation Manual (Document Request IDR 1.1); Ameritech Cost Allocation Manual (Document Request IDR 1.8) and Part 711 (available on ICC website).

- The SBC Center for Learning, Inc. (CFL) is listed as an affiliate in the ICAM; but not in the ACAM and no CFL service agreement was filed with the Commission on December 6, 1999. Our investigation of this matter disclosed that CFL was merged with SBC Services effective December 17, 1999. Training is now provided directly by SBC Services.
 - In some cases, allocation methodologies are different in the Part 711 and the ICAM.
5. SBC has complied with conditions set forth in the FCC Merger Order with respect to matters within the scope of this investigation.
- Condition 24 requires the Company to issue quarterly service reports; develop and file reports showing service quality to inter-exchange carriers; and continue to report ARMIS data on an operating company basis.
 - Condition 26 requires the Company to appoint an internal corporate Compliance Officer who will prepare and file an annual report addressing the Company's compliance with the merger conditions.
 - Condition 27 pertains to the retention of an independent auditor, approved by the FCC to provide an evaluation of compliance with the conditions and sufficiency of internal controls.
6. Documentation of the Company's Part 64 Cost Allocation System (PCAS) has not been updated to reflect changes in the ACAM.
- There is no indication that the PCAS binder has been updated to reflect annual revisions to the ACAM.
 - The Company's Part 64 Cost Allocation System Processes, Tables, Reports binder contains flowcharts, descriptions, reports and procedures for PCAS. The copy of this document provided for the audit has a revision date of May 1, 1995.

Quantified Results of Investigation

Not applicable to this chapter.

Recommendations for the Company

1. To ensure compliance with Commission requirements, file affiliate service agreements required to be filed and retain date-stamped copies of transmittal letters to document the filings. (Refers to Conclusion No. 2)
2. Update the ICAM to include all accounts reflected in the ACAM. (Refers to Conclusion No. 3)
3. Document the reasons for differences between the ICAM and Part 711, and request Commission approval for any deviations from the prescribed rules. Alternatively, petition the Commission for changes to Part 711. (Refers to Conclusion No. 4)
4. Update the PCAS binder to reflect all changes made since the last revision in 1995. (Refers to Conclusion No. 6)

Policy Issues for the Commission

None

Future Audit Issues

1. Test the Company's compliance with Commission requirements relating to the filing of affiliate service agreements. (Refers to Conclusion No. 2)